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THE WORLD'S OPINION PAGE

ECONOMICS

ANATOLE KALETSKY

Anatole Kaletsky is Chief Economist and Co-Chairman of Gavekal Dragonomics. A former columnist at the Times of London, the International New York Times and the Financial Times, he is the author of Capitalism 4.0, The Birth of a New Economy, which anticipated many of the post-crisis transformations of the global economy. His 1985 book, Costs of Default, became an influential primer for Latin American and Asian governments negotiating debt defaults and restructurings with banks and the IMF.

OCT 12, 2015

China is Not Collapsing

LONDON – One question has dominated the International Monetary Fund's annual meeting this year in Peru: Will China's economic downturn trigger a new financial crisis just as the world is putting the last one to bed? But the assumption underlying that question – that China is now the global economy's weakest link – is highly suspect.

China certainly experienced a turbulent summer, owing to three factors: economic weakness, financial panic, and the policy response to these problems. While none on its own would have threatened the world economy, the danger stemmed from a self-reinforcing interaction among them: weak economic data leads to financial turmoil, which induces policy blunders that in turn fuel more financial panic, economic weakness, and policy mistakes.

Such self-reinforcing financial feedback is much more powerful in transmitting global economic contagion than ordinary commercial or trade exposures, as the world learned in 2008-2009. The question now is whether the vicious circle that began in China over the summer will continue.

A sensible answer must distinguish between financial perceptions and economic reality. China's growth slowdown is not in itself surprising or alarming. As the IMF noted, China's growth rate has been declining steadily for five years – from 10.6% in 2010 to a projected rate of 6.8% this year and 6.3% in 2016.

This deceleration was inevitable as China advanced from extreme poverty and technological backwardness to become a middle-income economy powered by external trade and consumer spending. It was also desirable, because rapid growth was hitting environmental limits.

Even as the pace of growth slows, China is contributing more to the world economy than ever before, because its GDP today is $10.3 trillion, up from just $2.3 trillion in 2005. Simple arithmetic shows that $10.3 trillion growing at 6% or 7% produces much bigger numbers than 10% growth starting from a base that is almost five times smaller. This base effect also means that China will continue to absorb more natural resources than ever before, despite its diminishing growth prospects.

Yet China is causing high anxiety, especially in emerging countries, largely because financial markets have convinced themselves that its economy is not only slowing, but falling off a cliff. Many Western analysts, especially in financial institutions, treat China's official GDP growth of around 7% as a political fabrication – and the IMF's latest confirmation of its 6.8% estimate is unlikely to convince them. They point to steel, coal, and construction statistics, which really are collapsing in several Chinese regions, and to exports, which are growing much less than in the past.

But why do the skeptics accept the truth of dismal government figures for construction and steel output – down 15% and 4%, respectively, in the year to August – and then dismiss official data showing 10.8% retail-sales growth?

One reason can be found in the financier George Soros's concept of "reflexivity." Soros has argued for years that financial markets can create inaccurate expectations and then change reality to accord with them. This is the opposite of the process described in textbooks and built into economic models, which always assume that financial expectations adapt to reality, not the other way round.

In a classic example of reflexivity, when China's stock-market boom turned into July's

bust, the government responded with a $200 billion attempt to support prices, closely followed by a small devaluation of the previously stable renminbi. Financial analysts almost universally ridiculed these policies and castigated Chinese leaders for abandoning their earlier pretenses of market-oriented reforms. The government's apparent desperation was seen as evidence that China was in far greater trouble than previously revealed.

This belief quickly shaped reality, as market analysts blurred the distinction between a growth slowdown and economic collapse. In mid-September, for example, when the private-sector Purchasing Managers' Index (PMI) came out at 47.0, the result was generally reported along these lines: "The index has now indicated contraction in the [manufacturing] sector for seven consecutive months."

In fact, Chinese manufacturing was growing by 5-7% throughout that period. The supposed evidence was wrong because 50 is the PMI's dividing line not between growth and recession, but between accelerating and slowing growth. Indeed, for 19 out of the PMI's 36 months of existence, the value has been below 50, while Chinese manufacturing growth has averaged 7.5%.

Exaggerations of this kind have undermined confidence in Chinese policy at a particularly dangerous time. China is now navigating a complex economic transition that involves three sometimes-conflicting objectives: creating a market-based consumer economy; reforming the financial system; and ensuring an orderly slowdown that avoids the economic collapse often accompanying industrial restructuring and financial liberalization.

Managing this trifecta successfully will require skillful juggling of priorities – and that will become much more difficult if Chinese policymakers lose international investors' trust or, more important, that of China's own citizens and businesses.

Vicious circles of economic instability, devaluation, and capital flight have brought down seemingly unbreakable regimes throughout history. This probably explains the whiff of panic that followed China's tiny, but totally unexpected, devaluation of the renminbi.

The renminbi, however, has recently stabilized, and capital flight has dwindled, as

evidenced by the better-than-expected reserve figures released by the People's Bank of China on October 7. This suggests that the government's policy of shifting gradually to a market-based exchange rate may have been better executed than generally believed; even the measures to support the stock market now look less futile than they did in July.

In short, Chinese economic management seems less incompetent than it did a few months ago. Indeed, China can probably avoid the financial meltdown widely feared in the summer. If so, other emerging economies tied to perceptions about China's economic health should also stabilize.

The world has learned since 2008 how dangerously financial expectations can interact with policy blunders, turning modest economic problems into major catastrophes, first in the US and then in the eurozone. It would be ironic if China's Communist leaders turned out to have a better understanding of capitalism's reflexive interactions among finance, the real economy, and government than Western devotees of free markets.

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